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Income Tax Rulings Directorate
Legislative Policy and Regulatory Affairs Branch
Canada Revenue Agency
Ottawa ON K1A 0L5

The Income Tax Technical News can be found on the Canada Revenue Agency Internet site at **www.cra.gc.ca**.

Taxation of Roth IRAs

A Roth Individual Retirement Arrangement ("IRA") is an individual retirement plan established pursuant to section 408A of the United States (the "U.S.") *Internal Revenue Code of 1986*. For U.S. income tax purposes, contributions to a Roth IRA are not deductible from income, and withdrawals are generally not included in income. For an overview of Roth IRAs, see Internal Revenue Service Publication 590, *Individual Retirement Arrangements (IRAs)*.

This Income Tax Technical News discusses the rules regarding the taxation of Roth IRAs in Canada for the most common situations. In addition, it outlines the procedures that an individual should follow to make an election (the "Election") under paragraph 7 of Article XVIII (Pensions and Annuities) of the *Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital* (the "Convention") to defer taxation with respect to the income accrued in the Roth IRA.

The following discussion addresses situations where the particular individual is resident in Canada for purposes of the *Income Tax Act* (the "Act") and the Convention, the individual is the owner of the Roth IRA, and distributions from the Roth IRA would not be taxable to the owner in the U.S. if he or she were resident in the U.S.

For questions regarding the Canadian taxation of a Roth IRA, contact the Income Tax Rulings Directorate at:

Income Tax Rulings Directorate
16th Floor, Tower A, Place de Ville
320 Queen Street
Ottawa ON K1A 0L5

Tel: **613-957-8953**
Fax: **613-957-2088**
Email: **itrulingsdirectorate@cra-arc.gc.ca**

For questions regarding the procedures for filing the Election, contact the Canadian Competent Authority at:

Competent Authority Services Division
International and Large Business Directorate
5th Floor, Canada Building
344 Slater Street
Ottawa ON K1A 0L5

1. Taxation of Roth IRAs in Canada

A Roth IRA is not a "foreign retirement arrangement," as that term is defined in subsection 248(1) of the Act and section 6803 of the *Income Tax Regulations*. Therefore the rules of the Act that apply to foreign retirement arrangements do not apply to Roth IRAs.

According to Publication 590, a Roth IRA can be an individual retirement account (i.e. a custodial account or a trust) or an individual retirement annuity (i.e. an annuity contract or an endowment contract from a life insurance company). A Roth IRA is not a registered plan under the Act, and income and distributions will therefore be taxed according to the rules that apply to custodial accounts, trusts, annuity contracts or endowment contracts.

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However, in many cases, Article XVIII of the Convention may apply to either defer or relieve taxation in Canada. These rules are discussed in more detail in section 2 below.

Custodial Accounts

The Canada Revenue Agency ("CRA") considers custodial accounts to be the equivalent of bank accounts. If the Roth IRA is a custodial account, interest credited or accrued under the account will, subject to the application of the Convention, be taxable on an annual basis to the individual under paragraph 12(1)(c) or subsection 12(4) of the Act. A subsequent distribution is not taxable in Canada in the year it is received.

Trusts

If the Roth IRA is governed by a trust, paragraph 94(1)(d) of the Act will apply, beginning with the taxation year in which the contributor has been resident in Canada for more than 60 months, whether or not the 60 months are consecutive. Until that point, the income of the Roth IRA trust may be accumulated and added to the capital of the trust. Once the contributor/beneficiary has been resident in Canada for more than 60 months in total, paragraph 94(1)(d) of the Act will apply to deem the Roth IRA to be a controlled foreign affiliate of the individual, commencing on January 1st of that year. As a result, when the foreign accrual property income (the "FAPI"), as defined in subsection 95(1) of the Act, of the trust is more than $5,000 in a year, the individual will, subject to the application of the Convention, be required to include in income the FAPI earned by the Roth IRA trust. If the income of the Roth IRA trust is paid or payable to the individual in the year, it will, subject to the application of the Convention, be included in his or her income under subsection 104(13) of the Act, and it will not be included in the FAPI of the trust by virtue of subsection 94(4).

A distribution of capital from a Roth IRA trust is not taxable in Canada to the individual.

Annuity or Endowment Contracts

The taxation of annuity contracts or endowment contracts is unique to the terms of the particular contract. The issuer, or a tax professional, can advise you.

Foreign Reporting

A Canadian resident individual may be required to file forms T1135, *Foreign Income Verification Statement*, T1141, *Information Return re Transfers or Loans to a Non-Resident Trust*, and/or T1134-B, *Information Return re Controlled Foreign Affiliates*, each year in respect of the Roth IRA. Since a Roth IRA is not a foreign retirement arrangement, the references on the forms to a "U.S. Individual Retirement Account (IRA)" do not apply to a Roth IRA. For more information on the foreign reporting rules, see the instructions on the respective forms, which can be found on the CRA website at **www.cra-arc.gc.ca**.

On August 27, 2010, the Department of Finance released draft legislation for consultation that proposes to amend the rules in the Act governing the taxation in Canada of non-resident trusts and the related foreign reporting rules. In particular, existing section 94 of the Act will be repealed and replaced with new sections 94 and 94.2. By virtue of clause (h)(ii)(D) of the definition of "exempt foreign trust" in proposed subsection 94(1) of the Act, a Roth IRA trust will generally not be subject to the rules governing non-resident trusts in proposed section 94 of the Act. However, proposed section 94.2 generally will apply to the Roth IRA trust, subject to the application of the Convention. Assuming the draft legislation is enacted as proposed, the new rules will apply to taxation years that end after March 4, 2010

2. Application of the Convention

The Fifth Protocol to the Convention ("Fifth Protocol") entered into force on December 15, 2008. In respect of taxes other than withholding taxes, the Fifth Protocol generally has effect for taxation years that begin after December 31, 2008.

The Fifth Protocol amended the definition of "pensions" in Article XVIII of the Convention. Under new subparagraph 3(b) of Article XVIII[1], a Roth IRA will be a "pension" for purposes of the Convention as long as no contribution is made to the Roth IRA after December 31, 2008, by or on behalf of the individual, while the individual is resident in Canada (a "Canadian Contribution").

A Canadian Contribution does not include rollover contributions from another Roth IRA or a Roth 401(k) arrangement that qualifies as a "pension" under Article XVIII. However, a conversion or rollover from qualified employer sponsored retirement plan accounts (such as traditional 401(k)s and profit sharing plans) or traditional IRAs to a Roth IRA after December 31, 2008 will be considered a Canadian Contribution.

If a Canadian Contribution is not made to the Roth IRA, the Roth IRA will continue to be subject to Article XVIII of the Convention. That is, under paragraph 7, the individual can elect to defer Canadian taxation with respect to the income accrued in the Roth IRA. The term "income accrued" means amounts that would otherwise be taxable to the individual in a taxation year under the Act, as outlined in section 1 above. Furthermore, under paragraph 1, distributions from a Roth IRA are exempt from taxation in Canada to the extent that they would be excluded from taxable income in the U.S. if the recipient were a resident of the U.S. This means that individuals are exempt from taxation on accrued income and distributions from a Roth IRA, provided that a valid Election is filed, a Canadian Contribution is not made, and distributions would not be taxable in the U.S. if the individual were resident there.

If a Canadian Contribution is made to the Roth IRA, a portion of the Roth IRA will cease to be considered a "pension" for purposes of Article XVIII. If a valid Election is made, income accrued up to the time of the Canadian Contribution will continue to be eligible for deferral. In addition, paragraph 1 will apply to distributions paid from the Roth IRA after the first Canadian Contribution to the extent that the distributions do not exceed the balance in the Roth IRA at the time immediately before the first Canadian Contribution.

However, any income accrued after that time will not be eligible for deferral under paragraph 7. In addition, paragraph 1 will not apply to distributions from the plan that exceed the balance in the Roth IRA at the time immediately before the first Canadian Contribution. As a result, Canada's domestic rules as outlined in section 1 above will apply. See the discussion in the Technical Explanation to Article 13 of the Fifth Protocol on the U. S. Department of the Treasury website at **http://www.treas.gov/press/releases/reports/tecanada08.pdf**

3. Roth IRA Guidelines

Prior to the Fifth Protocol, the CRA asked individuals who wished to elect under paragraph 7 (as it then read) to defer taxation of income accruing in a Roth IRA to make a "protective claim." The procedures for making a protective claim are no longer in place as of December 31, 2008. If you wish to defer or continue to defer taxation of income accrued in a Roth IRA after December 31, 2008, follow the guidelines set out below.

A. Who should file an Election?

Every Canadian resident individual who has a Roth IRA and who wishes to defer Canadian taxation on income accrued in the Roth IRA must file a one-time irrevocable Election in respect of each Roth IRA plan or account.

B. When should the Election be filed?

Resident in Canada before January 1, 2010: If you were resident in Canada in a taxation year ending before January 1, 2010, and had a Roth IRA in any of those years, you have until April 30, 2011 to make an Election in respect of the Roth IRA. The Election will be valid for all taxation years. The Election is required regardless of whether or not you filed a protective claim in respect of a prior year.

Acquiring residence in Canada after December 31, 2009: If you became resident in Canada in a taxation year ending after December 31, 2009, you have until the filing due-date for the first year of residence to make an Election in respect of a Roth IRA. The Election will be valid for the first year of residence and all subsequent taxation years.

C. How should an Election be made?

There is no prescribed form to make an Election in respect of a Roth IRA. The Election should be made in the form of a letter containing the following information for each Roth IRA plan or account:

1. Your name and address;
2. Your social insurance number and social security number;
3. Name and address of Roth IRA trustee or plan administrator;
4. Roth IRA account number;
5. Date that the plan was established;

6. Date that you became resident in Canada;
7. Balance of the Roth IRA as of December 31, 2008 or as of the date on which you became resident in Canada, whichever is later;
8. Amount and date of the first Canadian Contribution made to the Roth IRA, if any (see the definition of "Canadian Contribution" in section 2 above); and
9. A statement signed by you indicating that you elect to defer Canadian taxation under paragraph 7 of Article XVIII of the *Canada-U.S. Income Tax Convention* with respect to any income accrued in the Roth IRA for all taxation years ending before or after the date of the Election, until such time as a Canadian Contribution is made.

Keep a copy of your U.S. tax forms and records of transactions in the Roth IRA, including records of contributions, conversions, rollovers, income, and withdrawals. Although you do not have to provide this information to the CRA at the time of making the Election, these documents may be requested by the CRA to verify the taxable portion of your Roth IRA distributions, if any.

Send the Election to the Canadian Competent Authority at the address on the first page. Once an Election is made, you are not required to make another Election for subsequent years. Keep a copy of the Election for your records.

D. What if income from a Roth IRA was reported in a prior year?

If you reported income in Canada from a Roth IRA in a year prior to January 1, 2009, either on an accrual basis or because you received a distribution of income from the Roth IRA (that was not taxed in the U.S.), and a valid Election is made, you may make a request to amend the prior year return to remove that income.

A request may be made for any taxation year that ended within 10 years before the calendar year in which the request is filed. The request should be made at the same time as the Election and according to the requirements and procedures outlined in **Information Circular 07-1, *Taxpayer Relief Provisions***. Send the request to the Canadian Competent Authority and keep a copy of the request for your records.

E. What if a Canadian Contribution is made?

An Election in respect of a Roth IRA will be valid only up to the time of the first Canadian Contribution made (see the definition of "Canadian Contribution" in section 2 above). If you made a Canadian Contribution to a Roth IRA, the Election is no longer valid and all subsequent income earned or accrued in the Roth IRA after that time should be reported in your Canadian income tax return as required by the Act (see discussion in section 1 above).

4. Foreign Reporting

If you have filed a valid Election as described in this Income Tax Technical News and you have not made a Canadian Contribution to the Roth IRA, you are not required to file the foreign reporting information returns T1135, T1141 or T1134-B in respect of the Roth IRA.

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[1] Unless otherwise noted, all subsequent references to "paragraph" are to paragraphs of Article XVIII of the Convention.